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38 Degrees

Getting serious: how the UK government helps private equity executives to pay lower tax rates than nurses and teachers, and what could be done about it

written by Mike Lewis on behalf of 38 Degrees

"I was shocked to see that some of the very wealthiest people in the country have organised their tax affairs - and to be fair it's within the tax laws - so that they were regularly paying virtually no income tax. And I don't think that's right." – George Osborne, Chancellor of the Exchequer, April 2012[1]

"We will make changes to create a fairer tax system….to ensure that those with the broadest shoulders bear a fairer share of the burden." – Ed Balls, Shadow Chancellor, January 2014[2]

"In taxation, you should start at the top and work down….We think if you ask society to make a sacrifice, the broadest shoulders should make a contribution." – Nick Clegg, Deputy Prime Minister, October 2014[3]

SUMMARY

This briefing shows how:

1) **Private equity fund managers are able to pay tax on much of their income at just 28% - income which in a good year may be between £1.2 to £15 million or more.[4]** In some cases, fund managers may lower this further to pay as little as 10% (or even 0% if they are not domiciled in the UK). They also avoid national insurance contributions on such income.

2) **This is far less than the 45% rate of income tax that even their colleagues elsewhere in the financial sector pay on income over £150,000. At 28%, a millionaire private equity fund manager is paying a lower tax rate on much of their income than a matron in a UK hospital ward, despite earning 170 times more.[5]**

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[1] Quoted in Robert Winnett and James Kirkup, 'George Osborne: I'm going after the wealthy tax dodgers', *Daily Telegraph,* 8 April 2012.

[2] Ed Balls MP, speech to Fabian Society New Year conference, 25 January 2014.

[3] Nick Clegg MP, comments to Sky News' 'Sunrise' programme, 6 October 2014, reported by Press Association.

[4] Heidrick & Struggles, *2014 Private Equity EMEA Compensation Survey*. This range represents the smallest to largest mean 'Base + Bonus + Carry' remuneration reported for Managing Director- and Principal-level investment personnel.

[5] PE executive pay rates taken from mean salary + bonus + carry of PE managing director in Heidrick & Struggles, *2014 Private Equity EMEA Compensation Survey.* Senior matron salary taken from top of Band 8A of NHS Agenda for Change pay scales for 2014-15, http://www.rcn.org.uk/__data/assets/pdf_file/0007/572812/nurse-pay-scales-nhs-agenda-for-change-england-2014-2015.pdf.

3) Where they are able to shrink their tax rates significantly below 28%, and factoring in the avoidance of National Insurance contributions, some **private equity executives are paying lower tax rates on their 'carry' income than classroom teachers and nurses, despite earning over 200 times as much as the average mid-career teacher,** and **over 300 times as much as the average nurse.**

4) This tax break for private equity executives may be sacrificing potential UK tax revenues of **between £280m-£700m** every year.

5) Chief Secretary to the Treasury Danny Alexander has called this situation "utterly disgraceful", yet his government has done nothing to change it. In fact, this tax outcome is deliberately and explicitly protected by **two special tax deals** made by HMRC - under both Conservative and Labour governments - with the private equity industry's lobby organisation, the British Venture Capital Association (BVCA), and without the approval of Parliament.

6) **The private equity industry and its bosses are amongst the leading donors to the current government.** New analysis of political donations for this report shows that of the 93 political donors that have sat down to dinner with David Cameron and cabinet ministers in the last year as part of the 'Leaders Group' of major donors, 16 (more than one in six of this group of elite donors) have been from the private equity industry. On the other side of the party divide, since 2012 the industry's lobby organisation, the BVCA, has become the second-largest funder of the centrist Labour Party organisation, Progress.

7) **The 2015 Finance Bill, as it stands, will explicitly exempt the private equity tax loophole from new anti-tax-avoidance legislation aimed at the financial sector,** by introducing a special exemption for private equity bosses' main form of low-tax income ('carried interest').

8) **A simple legislative change, similar to those already achieved in some other European countries, could close this tax loophole used by private equity millionaires,** while protecting genuine entrepreneurs, and ensuring that some of the highest earners of the financial sector start to pay a fairer share in tax. This could be introduced in the 2015 Finance Bill, given the political will to do so.

INTRODUCTION: The Private Equity Industry in the UK

Private equity (PE) firms raise money from investors – ranging from wealthy individuals to pension funds and banks – and use this money to buy other companies, sometimes buying private companies, and sometimes taking publicly-owned companies off the stock market and into private hands. Their aim is to raise the value of these companies and extract value from them for their investors, both through dividends and other profit distributions while they own them, and by selling the companies again at a substantial profit, typically 3-5 years after purchase.[6]

In recent years a sizeable portion of the UK economy – and of the UK's public services – has become owned and effectively managed by PE funds. The Bank of England estimates that some 5% of UK companies (by assets) are now owned by private equity.[7] UK private equity has in practice been particularly strongly involved in buying-up privatized utilities and outsourced public services:[8]

- PE-backed investment consortia own 11 of the UK's 21 water companies;[9]
- PE funds own companies providing over 13% of all the health and social care provided (increasingly) by private companies in the UK, with particularly heavy involvement in mental health and community health - those public sector health services most widely outsourced to private providers;[10]
- One in every six pounds spent in the UK on mental health hospitals, for instance, goes to a private-equity-owned private company.[11]

In short, most people in the UK probably now contribute, directly or indirectly, to the profits of the private equity industry in some way: by paying for utilities and services like water and sewerage; working for their companies (the industry's own estimates suggest that over half a million people in the UK are employees of PE-owned businesses);[12] or otherwise contributing to public funds spent on outsourced public services.

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[6] Though this typical 3-5 year exit horizon has increased slightly since the financial crisis: see Ernst & Young, *Global Private Equity Watch 2013: Exits in Brief* (http://www.ey.com/GL/en/Industries/Private-Equity/Global-PE-Watch-2013---Exits-in-brief accessed 6 January 2015).

[7] David Gregory (Bank of England), 'Private Equity and Financial Stability', *Bank of England Quarterly Bulletin 2013 Q1*, pp. 38-47.

[8] See British Venture Capital Association, *BVCA Private Equity and Venture Capital Report on Investment Activity 2013* (Autumn 2014), Table 7.

[9] For full list, see http://www.ofwat.gov.uk/industrystructure/ownership/prs_web_parentco.

[10] 2012 figures, estimated by Laing and Buisson on behalf of the BVCA: Laing & Buisson, *The Role of Private Equity in UK Health and Care Services* (July 2012), http://www.bvca.co.uk/Portals/0/library/documents/LB_PrivateEquity_2012.pdf.

[11] 2012 figures, estimated by Laing and Buisson on behalf of the BVCA: Laing & Buisson, *The Role of Private Equity in UK Health and Care Services* (July 2012), http://www.bvca.co.uk/Portals/0/library/documents/LB_PrivateEquity_2012.pdf.

[12] http://www.bvca.co.uk/PrivateEquityExplained/FAQsinPrivateEquity.aspx accessed 7 January 2015.

Such huge assets are run by a select group: just 8,000-10,000 people work in PE firms in the UK, of which perhaps half to two-thirds are actually involved in running the funds themselves.[13]

These few thousand people are remarkably well remunerated. In the words of Stephen Feinberg, head of the well-known PE firm Cerberus Capital: "In general, I think that all of us are way overpaid in this business. It is almost embarrassing."[14] Industry pay surveys indicate that in years when fund managers receive a share of the profits resulting from the sale of their fund's companies - which will depend on how many companies their funds own and how often they sell each of them, typically 3-5 years after their acquisition – the average European PE firm's managing directors can expect to receive around £8 million in total personal compensation. The largest funds pay out £15 million or more. Even more junior directors/principals can expect to receive some £1.2 million.[15] These figures will be conservative for London, which has the highest-paid private equity executives in Europe.[16]

Source: Headrick & Struggles, 2014. N.B: the carry represents the "expected return on total carry participation", presumably spread over a number of years.

Taxing Private Equity executives

PE executives' large pay packets are substantially due to the fact that on top of salaries and bonuses paid out of a PE fund's management fees, the investment executives in a PE firm also receive a major portion of the profits of the funds that they manage over a certain level. This share – usually 20% of the fund's profits, and typically in exchange for a nominal investment into the funds on the fund managers' own account[17] - is called "carried interest", or "carry". [18]

[13] Estimated UK PE employment figures in Preqin Ltd, *Preqin Private Equity Compensation and Employment Review*, various years 2011-13; estimates of proportion of 'deal-making' employees from figures for number of employees per firm, and median numbers of 'deal-making employees dedicated to Fund' (Europe) and 'median number of employees receiving a promote/carried interest in fund' (Europe): Preqin Ltd, *Preqin Private Equity Compensation and Employment Review 2013,* pp. 22, 26.

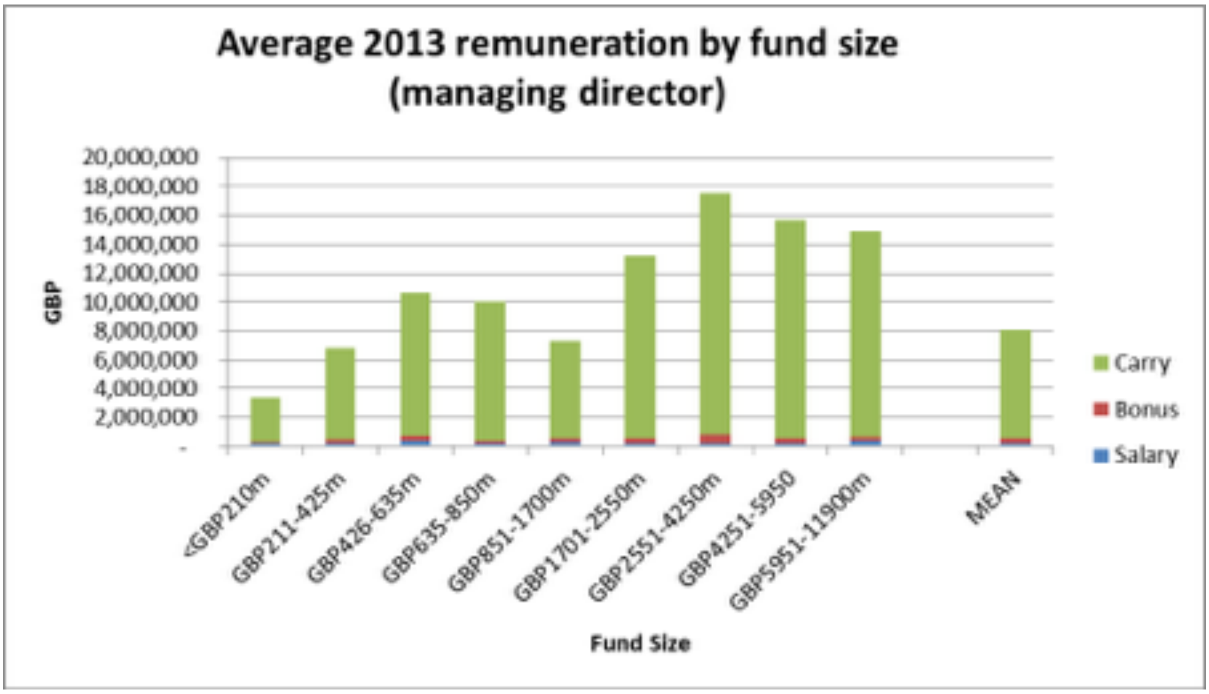
[14] 'Cerberus' Feinberg says PE executives 'way overpaid'', *Reuters,* 7 June 2011.

[15] Heidrick & Struggles, *2014 Private Equity EMEA Compensation Survey*, p. 8. Converted using 2013 average 2013 EUR:GBP exchange rates from www.oanda.com, queried 7 January 2015.

[16] Heidrick & Struggles, *2014 Private Equity EMEA Compensation Survey*, p. 11.

[17] In theory PE executives must contribute as much capital into the fund as the percentage of fund returns they receive; but in practice, leading UK tax advisors Linklaters assert, this can be "a nominal amount" since the majority of the capital provided by other investors comes as loans. See Linklaters, *Private Equity Taxation: An Overview* (February 2012), p. 21, http://www.linklaters.com/pdfs/mkt/tax/Private_Equity_Taxation_Brochure.pdf accessed 7 January 2015.

[18] The vast majority of funds (over 90% excluding fund of funds and secondaries) charge a standard 20% carry, and two-thirds charge this after the fund has an annual return of over 8% (the 'hurdle'): Preqin Ltd, *Preqin Private Equity Compensation and Employment Review* 2010, p. 38.



Private equity funds are generally structured as a sequence of partnerships, in which the fund managers work with the managing 'general partners' of the fund, and the investors participate as 'limited partners'. The fund managers' entitlement to their slice of the profits (the 'carry') is typically held for them by another limited partner alongside the ordinary investors.

This means that current UK tax law potentially treats at least some of the 'carry' paid to fund managers as gains from those executives' investments, despite the fund managers rarely contributing commensurate capital into the funds themselves. The result: despite the 'carry' – in some years the majority of PE executives' pay packet – being remuneration for their functions as fund managers, not the fruit of their own investments, nonetheless it is taxed as capital gains at 28%, not ordinary income at 45%. PE executives also avoid paying National Insurance contributions on this multi-million-pound income.

Paid by the investors to the private equity fund	→	**Paid to the fund managers as…**	→	**Taxed?**
Management fee *(typically 2% of the assets under management)*	→	Salary + bonus	→	Income tax + NIC
Profits from the investment fund *(typically 20% of the profits if the fund performs over a certain level)*	→	Carried interest	→	Capital gains tax

In some cases, PE executives may be able to bring tax rates on the 'carry' down even further. 'Entrepreneurs' relief' is a tax break that reduces the tax rate on £10 million of capital gains to just 10% for those owning more than 5% of a company and who are also directors (or employees) in the company. Previously called 'taper relief', entrepreneurs' relief is intended to incentivise entrepreneurs investing their own money in new businesses. The rules to qualify for this additional tax break were tightened in 2008 (outlined below), in part to stop private equity bosses from qualifying;[19] and the private equity industry evidently feels it does not apply to them in enough cases – its lobbying body the BVCA has been advocating expanding entrepreneurs' relief to make it easier for private equity bosses and venture capitalists to qualify.[20]

Nonetheless several UK-based tax advisers suggest that PE fund managers can *in some circumstances* continue to qualify for entrepreneur's relief where the fund managers also form the new management teams of companies bought by their funds: potentially allowing a tax rate of just 10% on the first £10 million of their 'carry' income.[21] £10m is a lifetime limit – after this, the rate rises back to 28% (still much less than 45% plus NI contributions that is due on most taxpayers' income at this income level). While £10m may not be much for an

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[19] See e.g. Latham & Watkins LLP, 'A global review of the taxation of carried interest', 21 December 2010, http://www.lexology.com/library/detail.aspx?g=429f8957-d7fc-4ca8-8449-384a3e078e9a.

[20] Tim Hames (chairman, BVCA), 'Chancellor must widen tax relief for entrepreneurs and investors to prove we're all in this together', *Daily Telegraph*, 13 October 2013, http://www.telegraph.co.uk/finance/comment/10376391/Chancellor-must-widen-tax-relief-for-entrepreneurs-and-investors-to-prove-were-all-in-this-together.html.

[21] Pinsent Masons, *Tax Issues for Managers in Private Equity Transactions* (updated May 2014), http://www.out-law.com/topics/tax/corporate-tax-/tax-issues-for-managers-in-private-equity-transactions; Visha Chopra (PWC Scotland), 'Entrepreneurs' relief - too big to ignore', 28 October 2010, http://pwc.blogs.com/private_business/2010/10/entrepreneurs-relief-too-big-to-ignore.html; Burges Salmon, *Private Equity News: Newsletter Winter 2013*, http://hb.betterregulation.com/external/Private%20Equity%20News%20-%20Winter%202013.pdf; Robert Maas of Carter Backer Winter, quoted in Penny Sukhraj, 'AS 2014: Clampdown on disguised fee income by fund managers', *Accountancy Live*, 4 December 2014, https://www.accountancylive.com/2014-clampdown-disguised-fee-income-fund-managers

executive earning several million pounds a year, compare this to the UK average pre-tax income of £20,300 – the average UK taxpayer would take 492 years to work through this £10m limit.

Even without entrepreneurs' relief, a millionaire PE executive can reduce their effective tax rate to well below that of a matron in a UK hospital ward, despite earning 170 times more.[22] With entrepreneurs' relief, they may pay less than half the effective tax rate of a classroom teacher earning 1/217th of their income, and 60% of the tax rate of an ordinary nurse earning 1/326th of their income.[23]

	Average remuneration	**Effective tax rate (income tax + NI contributions)**
Nurse	£24,644	20.0%
Classroom teacher (10 years' experience)	£37,124	26.9%
Senior matron in hospital ward	£47,088	32.2%
Senior private equity executive (managing director)	£8.04 million (including carry)	12.7% (with entrepreneur's relief) 29.4% (without entrepreneur's relief)

Without access to PE executives' tax returns, calculating the total cost to the UK government of the tax foregone in this way is difficult, given the opacity of the private equity industry and its remuneration. But estimates we have produced using the industry's own statistics and compensation surveys (Appendix 2) suggest that these loopholes – not including entrepreneurs' relief - may save UK private equity bosses **several hundred million pounds worth of tax every year.**

A unique sweetheart tax deal for a uniquely influential group of people

Just as successive UK governments have sought to woo the PE industry, so the political influence of the industry and its members is considerable, though unsurprising given their wealth.

New analysis of party donor disclosures undertaken for this report shows that **of the 93 political donors that have sat down to dinner with the Prime Minister and Conservative cabinet ministers in the last year as part of the 'Leaders Group' of major donors, 16 (over a sixth of this group of elite donors) have been from the private equity industry** - a startlingly high proportion for an industry that employs fewer people in the UK than fish processing or paint manufacturing (industries, needless to say, considerably

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[22] PE executive pay rates taken from mean salary + bonus + carry of PE managing director in Heidrick & Struggles, *2014 Private Equity EMEA Compensation Survey*. Senior matron salary taken from top of Band 8A of NHS Agenda for Change pay scales for 2014-15, http://www.rcn.org.uk/__data/assets/pdf_file/0007/572812/nurse-pay-scales-nhs-agenda-for-change-england-2014-2015.pdf.

[23] Effective tax rates calculated here include income tax and Class I NI contributions on salaries and bonuses.

less well-represented at David Cameron's private dinners).[24] We also calculate that the top 30 party political donors from the private equity industry have made some £7.19 million of political donations since 2008, almost exclusively to the Conservative Party.[25]

The PE industry lobby group the BVCA is itself is run by Tim Hames, former Special Adviser to Commons Speaker John Bercow. On the other side of the party divide, since 2012 the BVCA has also become the second-largest funder (after Lord David Sainsbury) of the centrist Labour Party organisation, Progress.[26]

Successive Labour and Conservative/Liberal Democrat governments have been keen to provide unique assurances to the PE industry that their tax arrangements will not be challenged. Most taxpayers are liable to HMRC questioning their tax affairs if tax inspectors believe that income has been incorrectly characterised or declared. **Uniquely, however, the private equity industry has lobbied to have a special guarantee issued by HMRC that its tax affairs will not be challenged.** In 2003 HMRC therefore signed a special Memorandum of Understanding with the BVCA (replacing a previous one signed in 1983).[27] This MoU explicitly guarantees that as long as a PE fund structures itself and its remuneration in a particular way, HMRC will make certain counterfactual assumptions which have the effect that the entirety of the carry is treated as capital gains.[28] No other industry enjoys such an agreement. Neither MoU was scrutinised by Parliament when introduced, and the intention of the government to negotiate another one in 2003 came to light during scrutiny of the 2003 Budget.[29]

Past U-turns on reforms

In 2007, research commissioned by the Treasury suggested that taper relief had little or no impact on incentivising investment and entrepreneurship, and that it was costing the UK over

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[24] Calculated from quarterly 'Leaders Dinners' disclosures published online by the Conservative Party at www.conservatives.com. This figure excludes two owners of a major investment group, both part of the 'Leaders' Group' which dined with ministers during 2014, but whose firm spun out its private equity arm in September 2013. For employment by industry, see Office of National Statistics, *Business Register and Employment Survey (BRES) 2013*, Table 2, http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Employment+by+Industry+Sector#tab-data-tables.

[25] Calculated from donations of cash and in-kind donations to political parties, party groupings and MPs registered by the Electoral Commission (www.electoralcommission.org.uk). The only exception we could identify amongst this top 30 was one donation of £25,000 to the Liberal Democrats in 2014, from a donor who also gave over £198,000 to the Conservative Party from 2008 to 2014.

[26] Electoral Commission records, queried at https://pefonline.electoralcommission.org.uk/Search/CommonReturnsSearch.aspx?type=advDonationSearch on 7 January 2015. See also the fuller declarations on Progress' own website at http://www.progressonline.org.uk/about-progress/how-progress-is-funded/ accessed 7 January 2015.

[27] http://www.hmrc.gov.uk/manuals/ersmmanual/ersm30520.htm.

[28] Specifically, the MOU commits HMRC to treating the PE fund manager as if they have paid market value for their interest in the proceeds of the fund, even if they have not in fact done so. This means that under the tax rules governing restricted securities, only capital gains tax is then paid on the proceeds of the fund manager's share of the fund (their carried interest).

[29] UK House of Commons, 'Capital Gains Tax: the 2008 reforms', *Standard Note SN4682*, 3 June 2010.

£6.2bn a year in foregone tax revenues (not all, of course, due to the PE industry).[30] 2007 also saw public controversy, and a parliamentary inquiry, over the ability of PE executives to exploit these tax loopholes to pay – in the words of Nicholas Ferguson, chairman of investment group SVG – "less tax than a cleaning lady".[31]

In response, the Labour government's 2007 budget –while not challenging the fundamental treatment of the carry income as capital gains - proposed to abolish taper relief. In return, the capital gains tax rate would be reduced to 18%, effectively raising the income tax rate on PE bosses by 8%, but still well below the rate paid by ordinary taxpayers.[32] In the words of a wealth management specialist in London, interviewed for this report: "Although the business lobby made a fuss, private equity executives were saying privately that they couldn't believe their luck: after all what difference does it really make to pay tax at 18% rather than 10% when you're making fifteen to twenty million pounds a year?"[33]

Nonetheless a raft of business groups including the British Chambers of Commerce, the Confederation of British Industry and the Institute of Directors, concerned about the impact of the blanket capital gains tax rise on the genuine owners of owner-operated businesses, wrote to the Chancellor demanding that he suspend the proposal. In January 2008, therefore, the Chancellor announced that taper relief would be replaced with 'entrepreneur's relief' allowing a 10% tax rate on the first £1m of returns on qualifying investments. This was increased to £2m in March 2010. In June 2010 the new Coalition government increased entrepreneur's relief to £5m, and £10m in the 2011 budget.

The 2015 Budget – business as usual

The Chancellor's 2014 Autumn Statement claimed that the 2015 Budget would crack down on tax avoidance, including efforts by fund managers in the private equity and hedge fund industries to have their fee income characterised as capital gains ('disguised income'). Chief Secretary to the Treasury Danny Alexander has repeatedly criticised the Labour party for allowing "millionaire [private] equity fund managers [to] pay a lower rate of tax on their gains than the person who cleaned their office paid on their income…an utterly disgraceful position".[34]

Yet examination of the draft legislation for the 2015 Finance Bill shows that it will explicitly exempt carried interest from these anti-avoidance measures, limiting the measures only to combat the disguising of management fees as capital gains.[35] Once again the private equity industry's unique tax arrangements continue to receive the government's special protection from potential HMRC challenge.

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[30] UK House of Commons, 'Capital Gains Tax: Background History', *Standard Note SN860*, 2 June 2010.

[31] 'The cleaner liable for 22% tax ... while her Apax bosses pay just 10%', *Evening Standard,* 24 June 2007.

[32] UK House of Commons, 'Capital Gains Tax: the 2008 reforms', *Standard Note SN4682*, 3 June 2010.

[33] Interview with wealth management specialist, London, January 2015.

[34] Remarks on BBC Newsnight, 22 March 2012; see also Commons Hansard, 6 July 2010, c205 and 11 December 2012, c192).

[35] See draft legislation at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385232/Disguised_fee_income.pdf.

Nonetheless the private equity industry is clearly on the back foot in relation to its tax deals, as reforms are increasingly being pushed forward across Europe. The BVCA appears increasingly concerned to influence UK tax policy: information released to the author by the UK Treasury shows that they have no record of their officials meeting either the BVCA or any private equity firm to discuss tax issues during 2011 and 2012, and only once in 2013; while four such meetings took place during 2014 alone, including three to discuss current international efforts to clamp down on tax avoidance (the OECD's 'Base Erosion and Profit-Shifting' programme). [36]

A solution

The ability of millionaire investment bosses to pay tax at lower rates than nurses and teachers has raised concerns amongst otherwise economically conservative bodies and politicians in Europe and the USA:

- In May 2014 the OECD, not known for radical tax positions, released a raft of recommendations to tackle rising income inequality in the OECD area. These included "[t]axing as ordinary income all remuneration, including fringe benefits, carried interest arrangements and stock options."[37]
- In the USA, controversy during the last presidential election regarding Mitt Romney's remuneration through carried interest sparked efforts by the Obama Administration in 2013-14 to close the 'carried interest loophole'. Previous efforts in 2013 failed thanks to Republic opposition, though the tax reform plan formulated during 2014 by Republican Dave Camp, chairman of the House Ways and Means Committee, also includes a measure to close the carried interest loophole. [38]
- In Sweden, the government recently took a test case to the country's Supreme Administrative Court attempting to re-characterise a PE fund's carry as ordinary income, though without legislative change the Swedish courts have rejected this effort.[39]

Although the carried interest loophole relies on an extra-statutory concession on the part of HMRC, closing it properly requires a change to UK tax law. We have commissioned external tax expertise to draft a simple legislative change that could be inserted into the 2015 Finance Bill. This would simply re-characterise carried interest as ordinary income in cases where it is effectively remuneration for investment managers investing other people's money, rather than gains from those managers' own investments. It is therefore designed to protect tax reliefs for real entrepreneurs while targeting the private equity industry's sweetheart tax deal.

Similar reforms, to varying degrees, have been introduced in other European countries. In 2009 the **Netherlands** introduced reforms which treat income from carried interest as ordinary ('Box 1') income from employment-type activities, taxed at progressive income tax

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[36] HM Treasury, response to Freedom of Information request, 22 January 2015.

[37] OECD, *Top Incomes and Taxation in OECD Countries: was the crisis a game-changer* (May 2014), http://www.oecd.org/social/OECD2014-FocusOnTopIncomes.pdf.

[38] 'Obama still wants to kill Wall Street's favourite tax loophole', *Business* Insider, 3 March 2014, http://www.businessinsider.com/obama-fiscal-year-2015-budget-2014-3#ixzz3KekDRq7J

[39] 'Swedish court denies *Nordic Capital* tax appeal', *Financial News,* 5 November 2014.

rates; and the allocation of carried interest itself to PE executives as a component of the executive's wages, also in theory taxable at progressive income tax rates.[40] **France's** 2013 Budget legislation ('Loi de Finances') backed down from fully characterizing carried interest as ordinary income after reported lobbying from the industry,[41] but still changed the law to apply progressive income tax rates to those gains, effectively raising the tax rate on carry from 19% to 45%.[42]

The real obstacle to UK reform is political will: the reticence of successive UK governments to challenge the private equity industry's unique sweetheart tax deal, and their efforts to ensure that millionaire private equity bosses can continue to pay a fraction of the top rate of tax on incomes most taxpayers could only dream of; all with a special guarantee from the UK tax authority that their tax arrangements will not be challenged.

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[40] Linklaters, *Private Equity Taxation: An Overview* (February 2012), p. 9, http://www.linklaters.com/pdfs/mkt/tax/Private_Equity_Taxation_Brochure.pdf accessed 7 January 2015. For a useful analysis of the post-2009 Dutch regime, see B. Bracken, School of Business and Economics, University of Maastricht, *Taxation of Carried Interest: Evaluation of Three Regimes*, thesis submitted in fulfilment of MSC in Fiscal Economics, April 2012, pp. 20-27. Linklaters and Bracken note that a specific loophole is included in the 2009 law allowing the taxation of carried interest income as 'Box 1' income: if a PE executive's carried interest income is sent to an intermediate holding company of which the executive receives more than 95% of the proceeds. In this case, the income is taxed at a flat 25% corporate tax rate; but this is only available where the executive or their holding company has more than a 5% stake in the PE funds (meeting the Dutch participation exemption threshold). There is no reason why a similar loophole/concession to the private equity industry would need to be incorporated into a UK version.

[41] Jérôme Le Berre (tax specialist, Herbert Smith Freehills), interviewed in 'Focus on Private Equity: French tax reforms getting carried away', *Investment Europe* (http://www.investmenteurope.net/regions/france/focus-on-private-equity-french-tax-reforms-getting-carried-away/?WT.rss_f=&WT.rss_a=Focus+on+private+equity%253A+French+tax+reforms+getting+carried+away), 2 November 2012.

[42] LOI n° 2012-1509 du 29 décembre 2012 de finances pour 2013.

APPENDIX 1: Proposed amendment to Finance Bill 2015 to tax carried interest as ordinary income

PART 7 INCOME TAX (EARNINGS AND PENSIONS) ACT 2003

DRAFT CHAPTER 2B: PRIVATE EQUITY FUNDS

433 Application of this Chapter

This chapter applies to employment-related securities if they are private equity fund securities.

434 "private equity fund securities"

For the purposes of this chapter employment-related securities are private equity fund securities if

(a) the employment relates to the operations of a collective investment scheme the sole or main purpose of which is to invest in unquoted shares or securities and

(b) sums may arise in respect of the employment-related securities (whether in connection with a disposal or otherwise) which directly or indirectly represent profits or gains on investments made for the purposes of the scheme.

434A Charge on sums arising

Any sum arising in respect of a private equity fund security which is not otherwise charged to income tax, less any consideration given for the acquisition of the private equity security to the extent such consideration has not already been taken into account in computing any charge to income tax, counts as employment income of the employee for the tax year in which it arises.

434B Definitions

In this Chapter "the employment" and "the employee" have the meanings indicated in section 421B(8).

NOTE: *in addition to the enactment of these sections:*

(a) the exclusion for "carried interest" should be deleted from new chapter 5E Part 13 Income Tax Act 2007 (Disguised investment management fees) which is to be introduced in Finance Bill 2015, and

(b) minor consequential amendments to existing legislation will be required.

APPENDIX 2: Estimating the UK exchequer cost of treating carried interest as capital gains rather than ordinary income

Estimating the remuneration of the private equity industry is difficult. Both the financial results and the individual remunerations of the private equity industry are opaque: in contrast to the reporting of executive pay required of public companies, private equity firms (and, indeed, the companies in their private portfolios) do not have to report publicly on their results and remuneration to the same extent. As a result, producing precise estimates of the exchequer cost of the carried interest loophole from publicly-available data is probably impossible.

The government will have the data to produce such estimates, of course, through the tax returns of private equity executives themselves, but ministers have insisted in the past that HMRC or the Treasury have made no estimate of the tax foregone due to the capital-gains tax treatment of carried interest.[43] This contrasts with the U.S., where Congress' Joint Committee on Taxation has drawn on tax return data to produce detailed estimates of the potential revenues raised by closing the carried interest loophole.[44]

In the absence of the necessary bottom-up data, we have attempted to use private equity compensation surveys and figures for the distributions made to PE investors to produce 'ball-park' estimates of the order of magnitude of the tax at stake, though these should be treated with considerable caution. (The private firms which have produced and published the data we have used bear no responsibility for the estimates we have produced). We have done this in two ways, both imperfect: they require a sequence of assumptions that mean these estimates should only be taken as 'ball-park' order of magnitudes for the amount of tax which might be at stake. It is incumbent on the UK government to produce proper estimates using the data at their disposal. In drawing up our methodologies and reviewing our figures we have also consulted other experts, including an academic financial economist previously involved in private asset management.

These estimates (subsections 1 and 2 below) suggest that as much as £700m of foregone UK tax revenues might be at stake each year. Comparisons with estimates produced by U.S. Congress for the corresponding tax foregone by the carried interest loophole in the USA suggest a **smaller figure**, but nonetheless that **several hundred million pounds** of foregone revenues is a credible estimate. The similar figures produced by our two 'bottom-up' and 'top-down' methods helps increase confidence in this as a ball-park estimate. We welcome critiques and suggestions for improvements of these figures.

[43] Lords Hansard, 21 March 2012, c178W

[44] Congressional Budget Office, 'Options for Reducing the Deficit: 2014 to 2023', 13 November 2013, https://www.cbo.gov/budget-options/2013/44804 (accessed 8 January 2015).

Summary of estimates:

Methodology	**Estimated cost to exchequer**
Preliminary sense check: the BCVA's own estimates for the size of UK private equity carry	£290 - 770 million
A 'bottom up' estimate from private equity compensation surveys	£760 million
A top-down estimate using figures for profit distributions made by the global private equity industry	£700 - 900 million

1) *Preliminary sense-check: the BVCA's own estimates for the size of UK private equity carry*

Before embarking on more complex calculations, we have used the BVCA's own 'rule of thumb' estimates for the amount of carry produced by UK private equity funds. In 2007 they stated that the average UK private equity fund's return was 1.39 x capital.[45] Thus, assuming that this return is after a standard carry of 20%, the BVCA suggests that "the [average] carry would represent 10% of the funds invested".[46]

Figures for global PE fundraising and asset management compiled by financial data firm Preqin Ltd suggest that in 2013 the PE industry had some US$3466 bn in their funds.[47] Preqin does not provide a UK-specific figure, but the financial industry lobby group TheCityUK, based on annual international surveys, has estimated that the UK's share of global PE investments is some 12.2%.[48] This would equate to US$423bn, or **£270bn.** If these funds pay out a 10% carry, which BVCA estimates would be over a 6-10 year timescale,[49] that would equate to £27bn, or (over the longest, and thus most conservative, BVCA-estimated timescale), some £2.7bn annually. Based on surveys of individual PE firms, Preqin Ltd estimates that some 72% of the carry goes to employees: this would be £1.94bn a year. Conservatively disregarding the (likely) possibility of some of this income being eligible for entrepreneur's relief, if this money was taxed at 45% (ordinary income) instead of 28% (capital gains), it would raise some **£330m** annually. This figure is also particularly conservative because it does not take into account the likely future appreciation of the value of the equity that these funds own; takes a conservative estimate for the return on capital of UK PE funds (the BVCA's most recent figures suggests that all funds since 1996 have produced an average return of some 1.56 x capital);[50] and assumes the longest possible

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[45] BVCA, *The Taxation of Carried Interest in Private Equity* (BVCA Briefing Paper: September 2007), p. 7

[46] BVCA, *The Taxation of Carried Interest in Private Equity* (BVCA Briefing Paper: September 2007), p. 7

[47] Preqin Ltd, *2014 Global Private Equity Report*, Fig. 3.1

[48] The CityUK, *Private Equity* (July 2012), Table 1, http://www.thecityuk.com/research/our-work/reports-list/private-equity-2012/).

BVCA, *The Taxation of Carried Interest in Private Equity* (BVCA Briefing Paper: September 2007), p. 7

[50] BVCA, *BVCA Private Equity and Venture Capital Performance Management Survey 2013* (Nov 2014), p. 17.

timescale for carry pay-out as estimated by the BVCA. At 6 years, the additional tax raised would be some **£550m** annually; and at an average fund return of 1.56 x capital, as much as **£770m** annually.

Using 2007 figures for fund returns is of course questionable: the value of all assets plunged after 2007, and private equity's asset growth may not have yet recovered to pre-crisis levels. The BVCA's own latest figures[51] produce fund return estimates for funds established up to 2009, which have anticipated returns of around 1.21xcapital.[52] Using this as a typical 'post-crisis' fund return figure would suggest typical carries of some **£**1.7bn a year, leading to typical annual revenues foregone of some **£290m** if the carry is paid out over 6 years (rising, of course, as the industry's assets under management increase).

We now proceed to estimates using more detailed data-sets, which suggest higher figures, but within this ballpark range.

2) A 'bottom-up' estimate from private equity compensation surveys

We have taken commercially-produced figures for the number of people employed in the global and UK private equity industries, and the average employment size of PE firms, to produce an estimated model of the numbers of employees in UK PE firms of different sizes and at different remuneration levels.

- Using estimates by alternative assets research company Preqin Ltd that there are some 4270 PE firms globally,[53] and some 89000 people employed globally in the industry, of which 10-11% are employed in the UK,[54] we estimate that there are some 470 UK PE firms.

- We estimate the size of total assets under management by UK PE firms by combining estimates of global PE assets under management produced by Preqin Ltd, and the UK share of such assets estimated by financial sector lobby group TheCityUK.[55]

- We then assume that these 470 UK PE firms are distributed by size normally around the estimated mean assets under management (£0.57bn), with a standard deviation of £40bn, the SD of a different dataset of PE funds produced for a 2004 study of European PE funds by the Department for Financial Management and Capital Markets, Technische Universität München.[56] (In practice it is unlikely that PE firms

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51 BVCA, *BVCA Private Equity and Venture Capital Performance Management Survey 2013* (Nov 2014), p. 17.

52 Running indices for UK private equity fund returns are constructed by Bloomberg, but not available without subscription, and so were not available for these calculations.

53 Preqin Ltd, *2010 Private Equity Compensation and Employment Review*; versions of this publication produced in more recent years estimate simply that there are 'over 4000' firms.

54 Preqin Ltd, *Private Equity Compensation and Employment Review*, 2010, 2011 and 2013 years.

55 Preqin Ltd, *2014 Global Private Equity Report*, Fig. 3.1;UK share of PE investments estimated by City lobby group TheCityUK (The CityUK, *Private Equity* (July 2012), Table 1, http://www.thecityuk.com/research/our-work/reports-list/private-equity-2012/).

56 C. Kaserer and C. Diller, *European Private Equity Funds: A Cash-flow-based Performance Analysis* (May 2004), Table 1.

are distributed normally by asset size, but available up-to-date data makes it hard to estimate the actual distribution of firms by asset size. Using a normal distribution probably produces conservative estimates of the numbers of larger (and better remunerated) firms, since this 2004 study found that the mean fund size was considerably higher than the median, suggesting that fund sizes may be skewed towards the top end.)

- We then produce a normally-distributed population of 470 PE firms in different bands of assets under management.

- We use Preqin Ltd's PE employment surveys' figures for the average number of employees per firm size,[57] the number of employees per firm eligible for carry in firms of different sizes,[58] and the average number of managing directors in different firms,[59] to estimate an idealised population of investment employees in these 470 firms at managing director, principal and associate levels.

- We then used average figures for salary, bonus and carry for European PE investment employees of firms of different sizes produced by anonymous surveys undertaken by executive recruitment firm Heidrich & Struggles during 2013.[60] These figures are probably conservative for the UK, which has the highest-compensated PE executives of any market surveyed by Heidrich & Struggles.[61]

- We used these to estimate the average carry awards to our idealised population of UK PE executives (see table below).

- We assumed that these carry awards are taxed at 28% capital gains rate, and compare the tax that would otherwise be due at 45% (for total compensation over £150,000) and 40% (for compensation below £150,000).

- This produces a total carry across the PE executive population of £22.4bn, on which revenues of £3.8bn are foregone by treating the carry as capital gains, not ordinary income. This excludes any use of entrepreneur's relief, and ignores any additional NI contributions that might be due on carry treated as ordinary income; both of which would increase the revenue foregone.

- The carry figure quoted in Heirdich & Struggles is the expected return on the executive's total carry participation across all the funds in which they are involved. We assume (conservatively) that this carry income is achieved over a 5-year period (the longer end of a 3-5 year investment cycle), to produce an annual foregone revenue figure of around **£760m.**

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[57] Preqin Ltd, *Private Equity Compensation and Employment Review*, 2013, p. 8, Fig. 1.3

[58] Preqin Ltd, *Private Equity Compensation and Employment Review*, 2013, p. 30 Fig. 6.11

[59] Preqin Ltd, *Private Equity Compensation and Employment Review*, 2013, p. 35, Fig. 6.24

[60] Heidrich & Struggles, *2014 Private Equity EMEA Compensation Survey*, pp. 7-8 (http://www.heidrick.com/Knowledge-Center/Publication/2014-Private-Equity-EMEA-Compensation-Survey). We did not used Preqin compensation survey figures as these do not disaggregate carry and long-term incentive awards.

[61] Heidrich & Struggles, *2014 Private Equity EMEA Compensation Survey*, p. 11.

FIRM SIZE (assets under management, £m)	0-210	211-425	426-635	635-850	851-1700	1701-2550	2551-4250	4251-5950	5951-11900
Estimated number of firms per asset band	50	80	96	92	114	10	10	9	9
Average number of employees per firm	9	13	15	19	36	36	36	70	99
Estimated number of employees per firm eligible for carry	5.4	7.8	9	11.4	21.6	21.6	21.6	42	59.4
Estimated number of managing directors per firm	1	2	3	4	5	5	5	7	10
Estimated number of principals per firm	2	3	3	3	7	7	7	15	20
Estimated number of associates per firm	2	3	3	4	10	10	10	20	29
Estimated number of managing directors	50	160	288	368	570	50	50	63	90
Estimated number of principals	100	240	288	276	798	70	70	135	180
Estimated number of associates	100	240	288	368	1140	100	100	180	261
Average carry - managing directors	3141041	6366975	9847588	9592909	6791440	12564164	16723921	15110954	14262024
Average carry - principals	1273395	1697860	1612967	848930	2037432	2971255	4584222	4669115	8489300
Average carry - associates	594251	1103609	509358	84893	848930	1188502	933823	424465	84893
Total carry - managing directors	157052050	1018716000	2836105344	3530190512	3871120800	628208200	836196050	951990102	1283582160

Total carry - principals	127339500	407486400	464534496	234304680	1625870736	207987850	320895540	630330525	1528074000
Total carry - associates	59425100	264866160	146695104	31240624	967780200	118850200	93382300	76403700	22157073
Tax foregone - managing directors @45%	26698849	173181720	482137909	600132387	658090536	106795394	142153329	161838317	218208967
Tax foregone - principals @45%	21647715	69272688	78970864	39831796	276398025	35357935	54552242	107156189	259772580
Tax foregone - associates @40%	954465	1508344	284384	2500238	3099956	129305.76	27434.16	0	709727
Tax foregone - associates @45%	8750107	42890427	24535291	1768903	160131029	20021351	15836126	13282354	2761256

3) ***A 'top-down' estimate using figures for profit distributions made by the global private equity industry***

- We have started with annual estimates of profit distributions made to private equity investors (LPs) by the global private equity industry, produced by financial data firm Preqin Ltd.[62]
- We assume that these are distributions made after a 20% distribution[63] to the PE firm (the general partnership, GP).
- We assume that distributions to PE firms in different regions of the world are proportional to the investments raised in different regions of the world, and use this (untested) assumption to estimate the proportion of the fund profits distributed globally which are distributed by UK PE firms, using geographical splits for PE investments estimated by TheCityUK.[64]
- We then use figures produced by Preqin Ltd for the average proportion of GP distributions allocated to employees (72%)[65] to estimate the annual distributions to UK PE executives. This will be a definite overestimate, since it does not take into account firm expenses deducted from the GP distribution, nor the management fee paid out of the fund before profit distributions to GPs and LPs are calculated; it also does not take into account the multitude of different ways in which profit distributions to GPs are organised, nor the fact that some of the distributions will be to GPs only since they will not have reached the 8% IRR hurdle that most funds require to pay out to GPs.
- We use these estimates for annual GP distributions to employees to estimate the tax foregone on the carry by treating the carry as capital gains, taxed at 28%, rather than as income taxed at 45%. This produces an estimate of between **£700-900m**. As explained above, this is almost certainly an overestimate, but the lower end corresponds to the order of magnitude of the 'bottom-up' estimate produced above from compensation survey data.

YEAR	2011	2012	2013
Total PE fund distributions to LPs (USD bn)	392	373	381
Estimated UK share	47.80	45.49	46.46
Total PE assets under management (USD bn)	3036	3273	3466
Estimated UK share (USD bn)	370.24	399.15	422.68
Estimated UK share (GBP bn)	230.84	251.87	270.20

[62] Preqin Ltd, *Private Equity Performance Monitor*, various years 2011-2014.

[63] The vast majority of funds (over 90% excluding fund of funds and secondaries) charge a standard 20% carry, and two-thirds charge this after the fund has an annual return of over 8% (the 'hurdle'): Preqin Ltd, *Preqin Private Equity Compensation and Employment Review* 2010, p. 38.

[64] The CityUK, *Private Equity* (July 2011 and July 2012), Table 1, http://www.thecityuk.com/research/our-work/reports-list/private-equity-2012/

[65] Preqin Ltd, *Private Equity Compensation and Employment Review 2011*, p. 49, Fig. 7.7

Estimated PE fund distributions to UK GPs (USD bn)	11.95	11.37	11.62
Estimated PE fund distributions to UK GPs (GBP bn)	7.45	7.18	7.43
Estimated GP share to employees (GBP bn)	5.37	4.09	4.23
Estimated tax foregone on UK share (GBP bn)	0.91	0.70	0.72